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ISSUES OF INSURANCE REGULATION AND SUPERVISION RELEVANT FOR DEVELOPING COUNTRIES

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INTRODUCTION

1. Under section B.1, paragraph (a), of its Work Programme the Standing Committee on Developing Services Sectors: Fostering Competitive Services Sectors in Developing Countries - Insurance, at its first session, on 1-5 February 1993, agreed to "Prepare a comprehensive study including:

(a) A review of critical areas of concern with regard to macroeconomic policies affecting the insurance sector and of insurance legislation, regulation and supervision in the light of ongoing or potential economic reforms *inter alia* of progressive liberalization and privatization of insurance markets - with particular emphasis on issues of prudential regulation and protection of policy holders"

2. This note has been prepared in response to that part of the Work Programme element that specifically refers to issues of prudential regulation and protection of policy holders.[1] It constitutes a summary of general findings and reflections which should provide the basis for a comprehensive review to be prepared for the third session on Insurance of the Standing Committee. The comprehensive review should especially focus on the experiences of developing and other countries undergoing economic reforms in the field of insurance regulation and supervision, and include examples of pertinent legislation and an evaluation of replies obtained from a questionnaire. To create such a report, competent government authorities and the insurance industry should contribute their comments, give an account of their experiences and make the relevant technical details available. The ultimate aim of the work undertaken will be to lay the ground for consensus building on the role, duties and powers of insurance regulatory and supervisory frameworks. It would thereby contribute towards the increasing cooperation and greater harmonization of insurance regulation and supervision among developing countries.

3. The intention of the present note is to draw attention to the importance of effective prudential supervision of the insurance sector. While the democratization process, movements towards a market economy, liberalization, deregulation and privatization may bring to the insurance markets of countries undergoing economic reforms more entrepreneurial freedom, better allocation of resources, increased productive efficiency and ultimately better quality services at lower prices, closer regulation and supervision of insurance markets may yield substantial benefits in terms of market efficiency and consumer protection. In the past many developing countries, where the monopoly insurer was in governmental hands, did not need a fully-fledged insurance supervisory framework. However, in the process of economic transformation, governments of developing countries need to adopt or enact new rules guiding the establishment and operation of insurance entities.

4. When reviewing their insurance regulatory and supervisory frameworks, developing countries can derive some guidance from what already exists in both developed and developing countries. Insurance regulation and supervision are

not a static that are established by a policy decision once and for all but have to be adapted constantly to changing requirements, perceptions and economic needs. In many countries, insurance regulation and supervision are at present under discussion and review. This is the case even in countries and regions with relatively advanced systems of supervision, as for example the United States of America and the European Union, where there seems to be a felt need to adapt regulatory systems to the evolution of the market or to new challenges. These developments offer interesting insights for developing countries that are in the process of improving their own regulatory system.

5. The present note first lists, in chapter I, the reasons for regulation and supervision of insurance and why many developing countries would benefit from transforming their regulatory and supervisory regimes. It then shows, in chapter II, how the insurance sector is controlled and supervised, and finally discusses how and which duties a supervisory authority can usefully perform.

Chapter I

REASONS FOR REGULATION AND SUPERVISION OF INSURANCE AND WHY DEVELOPING COUNTRIES NEED TO TRANSFORM THEIR REGULATORY AND SUPERVISORY REGIMES

A. Reasons for regulation and supervision of insurance

6. Historically regulation of insurance can be traced far back. As early as the fifteenth and sixteenth centuries there were well-established rules in Genoa, Barcelona, Bruges, Brussels and Antwerp to prevent abuse of insurance. Today, in most countries, if not all, there are specific regulations concerning the insurance business.

1. Establishment of a sound financial system

7. To develop sound financial markets which are one of the pillars of modern society, a prime prerequisite, besides political and economic stability, is the establishment of public confidence in the institutions that constitute the finance sector. Confidence can only be maintained if these institutions deliver services as promised. One of the duties of governmental authorities is to preserve the long-term stability of the financial system and the reliability of its components.

2. The protective function of insurance

8. Insurance is a major component of the financial sector. It is a risk transfer mechanism, whereby an insured transfers a risk exposure to an insurer in consideration for the payment of a premium. This is a tool of prime importance in modern economies: it enables the commercial sector as well as individuals to reduce and better manage the uncertainties of the future. In

several developed countries the ratio of aggregate insurance premiums (life and non-life premiums) to gross domestic product exceeds 10 per cent, which shows the importance in economic terms of the insurance industry.

9. The basic feature of the non-life insurance contract is that the insured buys a future promise of payment contingent upon the occurrence of specified events. This means that, first, the policyholder pays and then some time in the future the insurer may be required to reimburse the insured or a third party for a claim. This has several consequences, *inter alia*:

- the long-term reliability of an insurer must be beyond doubt;
- funds are entrusted to insurers which in large part constitute reserves to cover future obligations.

3. Protection of the insurance consumer

10. A potential imbalance may exist in the contractual relationship between the insured and the insurer. The insured pays his consideration at the very beginning of the contract (payment of the premium), but before the insurer is called to perform his part, time may have changed the security profile of the insurer. In view of the economic importance of insurance, this has led governmental authorities to enact regulations that should guarantee the long-term viability of insurers.

11. It is of interest to note that the first regulations governing insurance were enacted primarily to protect insurers against fraudulent action on the part of the insured (over insurance, multiple insurance, etc.). It was only at the turn of the twentieth century, especially with the appearance in some countries of compulsory insurances (motor, liability, workmen's compensation), and because of the increasing level of complexity of insurance contracts, that legislators started to concern themselves to an increasing extent with protecting the interests of the insurance consumer (policyholder and third parties). This trend has accelerated after the Second World War with the advent of "consumerism". Today the protection of the public and its fair treatment is cited as a major concern of most new insurance- related regulations. In a number of countries consumer protection has expanded the activities of the legislator beyond concern with reliability to include other considerations such as the availability, affordability and quality of insurance services.

12. The General Agreement on Trade in Services (GATS), recently concluded within the framework of the Uruguay Round negotiations, recognizes specifically that in regard to financial services member countries "shall not be prevented from taking measures for prudential reasons, including for the protection of policyholders ... or to ensure the integrity and stability of the financial system".[2]

4. Use of insurance funds for development purposes

13. Large funds are under the custody of insurers and are invested to produce additional returns. Under competitive pressure this additional income may enable the insurer to charge lower rates than would be usual when based on pure underwriting experience or it may improve the insurer's overall profitability. The management of these funds is thus very important both to insurers and insureds and may also play a significant role in the national economy. Appropriate regulations to channel these funds so as to target developmental areas of the economy may contribute to the overall economic development of the country. This issue has often been raised in connection with developing countries where investment money is often scarce and where funds held by insurers could be used for development purposes. However, it has been argued that imposition of strict investment rules may interfere with insurers' ability to maintain the necessary levels of liquidity and security in their investment portfolios. Such provisions may also deprive companies of investment possibilities yielding higher returns.

5. Development, effectiveness and efficiency of insurance markets

14. The development of a sound insurance industry is partly in the hands of the legislators and supervisors. They have to establish the framework for the healthy development of the insurance industry and to deal with the incidences of market failure and imperfections. This should benefit not only consumers but also the economy as a whole through better protection of the existing and future wealth of the country, the availability of more funds for investment purposes and the strengthening of State finances through higher tax incomes directly or indirectly deriving from the performance of the insurance sector.

15. Legislators and supervisors should ensure that the market develops towards optimal effectiveness and efficiency. This is usually best achieved in a competitive environment based on the principles of a market economy. Applied to insurance markets these principles include:

- Atomicity: the market should comprise a sufficient number of buyers and sellers to ensure that no individual player is able to acquire a dominant position.

- Transparency: market conditions should be made fully transparent. The products offered should attain a certain degree of homogeneity so that buyers can make objective comparisons between products on offer.

- Information: buyers and sellers should be able at any time, and at minimal cost, to inform themselves of prevailing market conditions, to make the best choice in terms of price and quality of service and to respond to changes in competitive conditions.

There are a number of constraints on the adaptation of these principles to insurance markets. To achieve an optimum market structure, (i.e. to have the

ideal number and size of companies) may require some trade-offs between security (reliability of insurance concerns), and concerns of competitiveness and diversity of products available. In terms of the products, there might also be trade-offs between product innovation and homogeneity. The interests of consumer protection and market efficiency may sometimes conflict, and the legislator should seek the optimum balance between the two.

B. Why should developing countries strengthen and improve the effectiveness of insurance supervision?

16. Before the emergence of a domestic insurance sector in developing countries, the typical market consisted of locally licensed agencies or branches of foreign insurance companies. This situation changed when countries began to realize the importance of insurance operations for the development of their national economies, and as foreign insurers became more sensitive to local considerations. Governments have since devoted much effort to create and strengthen national insurance markets. Lack of available private capital, ideological beliefs and the desire to attain certain development objectives in the shortest period of time encouraged developing countries to establish predominantly monopolistic or oligopolistic insurance markets with strong State participation in the form of ownership and intervention in daily operations. There was only a limited need for formal supervision. In two thirds of the developing countries the State today still has a direct role in the insurance sector.

17. The situation is, changing rapidly, however, and to establish or strengthen supervision of insurance has become a necessity for the following reasons:

(a) A clear trend has emerged towards establishment of competitive markets to which the principles of the market economy apply. Supervisory authorities have a primary role in ensuring that these principles are respected and that markets function efficiently.

(b) The democratization process is changing the attitude of politicians towards consumer protection. Because of national economic strategies, until recently laws and regulations in some countries have been producer biased, but they are now being altered to give greater consideration to consumer interests. This general trend is especially noticeable in attitudes regarding the insurance industry's treatment of policyholders, beneficiaries and third parties. Complaints from the public about insurance operations are treated with greater attention, as is demonstrated by the establishment of public complaints units within supervisory bodies and of ombudsmen's offices, as well as by regulations geared to speed up claims settlement.

(c) World trade liberalization in services includes insurance. The opening up of developing countries' domestic markets to foreign competitors will undoubtedly change prevailing market conditions significantly. In this

respect supervisory bodies have an important role to play. They have to ensure that rules flowing from the implementation of the GATS (General Agreement on Trade in Services contained in the Final Act of the Uruguay Round) in relation to such issues as market access, establishment, national treatment, non-discrimination and transparency are respected, and that no breaches occur in the rules of competition.[3]

18. In most developing countries there are objective reasons to change the regulatory and supervisory frameworks for insurance. A number of developing countries, especially in Latin America, have already made substantial changes with a view to liberalizing their insurance markets. In this respect supervisory authorities should play a pro-active role by proposing to their governments the new rules that are deemed necessary for adapting markets to changing conditions and for continuously assessing and fine tuning the implementation of these rules. Often liberalization processes are intermingled with deregulation, which is often seen as a reduction in regulatory activity. Certainly "administrative harassment" should be reduced, but the whole process should be directed towards greater autonomy of the management of insurance concerns rather than a reduction in the number of rules and regulations.

Chapter II

HOW TO CONTROL AND SUPERVISE THE INSURANCE SECTOR

19. Governments may influence the insurance industry in two ways: indirectly, through the implementation of macroeconomic policies, and directly, through ownership or by legislation containing regulations and stipulating practices to govern and supervise the activities of insurance-related concerns. Moreover, through State control, insurance operations may also be monitored on behalf of shareholders through statutory audits or by professional insurance associations through self-regulation.

A. Indirect control by the State

20. There is a close correlation between variations in the general state of an economy and the growth pattern of its insurance business. Whatever policies are applied by governments to correct imbalances in their economies, they also have an impact on insurance.

1. Monetary policies

21. Any movement in interest rates has an immediate bearing on the insurance sector. Investment and rating strategies have to be adjusted and the profitability and competitiveness of certain insurance products (life insurance) will also vary as a consequence of interest rate variations.

22. The use of other instruments for controlling the national money supply and rate of inflation, such as reserve requirements of the banking sector and open market interventions, have an indirect bearing on insurance. Currency exchange control mechanisms have an impact as well, especially in relation to reinsurance operations.

2. Fiscal policies

23. The general level of corporate and individual taxes obviously affects the insurance industry and the consumer. The development of the insurance industry can be promoted or hampered through the fiscal treatment of insurance operations and of specific contracts. Premium taxes or tax privileges linked to certain categories of insurance contracts (for example, life insurance) determine the pace of growth of the business. Government spending policies aimed at inducing economic activity also affect the insurance business.

B. Direct control by the State

24. Governments may control the insurance industry through direct ownership, enactment of laws, regulations and practices, and by supervision of the sector.

1. Direct ownership

25. Through direct ownership of insurance concerns, governments are in a position to exercise whole or partial control of the business, and are thus able to impose strategies to attain certain set political, social and economic objectives. However, it has been argued that, under enhanced competitive market conditions, private sector entities would outperform publicly owned concerns.

26. In recent years a number of countries have introduced market economy principles and have privatized publicly owned entities including insurance companies, altering the structure and functioning of their markets. Monopolies and oligopolies under strong State influence are progressively replaced by competitive markets.

2. State regulation and supervision of insurance

27. The countries that have given greater consideration to the protection of insurance consumers, to insurance company security and to market efficiency, have altered or introduced new regulatory and supervisory frameworks governing insurance operations. These frameworks generally include rules regarding:

- the formation, establishment and licensing of insurance entities;
- the ongoing operations of insurance companies. These cover, *inter alia*, financial aspects such as capital, reserve and solvency requirements, approval of contract terms and rates, documentation and required levels of qualifications, experience and competence for persons managing an insurance entity.;

- portfolio transfers, suspension of trading, and liquidation of insurance operations, as well as mergers and acquisitions;

- consumer protection measures such as guarantee funds, ombudsmen and public complaints handling offices;

- international cooperation and practice, and

- insurance-related services.

These rules are discussed in more detail in chapter III of this document.

28. The extent of supervision varies from one country to another. The countries with stringent supervisory regimes such as Germany, Japan and Switzerland still substantially supervise a wide range of activities. Authorities of these countries consider that supervisory bodies should not only check the solvency of insurance companies but also verify that an adequate balance exists between premiums and insurance benefits arising from insurance contracts offered in their markets, and furthermore ensure that insurance contracts comply with specific legal provisions providing for the fair treatment of policyholders.

29. Some other countries like the United Kingdom and the Netherlands, which have traditionally a more relaxed approach to supervision, rely more on market forces. Here governmental authorities concentrate on control of the financial situation (solvency) and allow competitive forces to determine rate setting, design of insurance contracts and other insurance business matters.

30. The level of supervisory intensity in most countries varies between the above examples, reflecting the emphasis placed on either consumer protection or market efficiency. To decide which direction emphasis on supervision should take, developing countries establishing new legal frameworks might begin by assessing the degree of sophistication of the insurance consumer in their countries. If governmental authorities "think their citizens can look after themselves and are competent in economic matters, organization of the markets may primarily be left to insurance companies. If policy holders are considered inexperienced in insurance matters, they may require more protection, and extensive insurance supervision would be the right answer."[4]

C. Three approaches to insurance regulation and supervision

31. To illustrate the fundamental differences in insurance supervisory philosophies, it is useful to give a brief description of the main features characterising the supervisory frameworks of the United Kingdom, Germany and the United States of America. Membership of the European Union has recently resulted in some convergence of the regulations governing insurance operations in both the United Kingdom and Germany, but previously they tended to represent the two extremes of the approach to supervision. The United States of America as the third example is interesting not only because it is the largest insurance market

in the world (with a world market share of 34.42 per cent of total business, and 42 per cent of world non-life insurance business)[5] but also because insurance supervision continues to be the prerogative of each individual state. However, there are now initiatives to examine the extent to which federal supervision could be introduced, and this, together with harmonization within the European Union, may be the forerunner to the harmonization of world insurance practices.

1. Regulation and supervision in the United Kingdom

32. Historically, the Government has interfered little with the insurance market in the United Kingdom and it is only recently that "light to moderate regulation has been imposed".[6] The Government's philosophy has traditionally been not to interfere in business transactions and to limit State intervention to cases of serious threats to the public interest. Insurance regulation has often evolved as a result of scandals and failures, while more recent changes have been triggered by the United Kingdom's membership of the European Union. The introduction of the Single European Act has influenced the United Kingdom's regulatory framework in the direction of more governmental supervision of insurance companies.

33. Today, the various types of insurance undertakings fall under different supervisory regimes:

- Insurers, including life insurers (though the sales force of the latter is partly governed by the Financial Services Act 1986) and reinsurers are regulated through statutory regulation (Insurance Companies Act). Such regulation is under the supervision of the Board of Trade.

- Lloyd's of London, insurance intermediaries and brokers are governed by statutes requiring self-regulation.

History

34. Although the United Kingdom has insurance legislation dating back to before the fifteenth century it was the collapse of a life office (the Albert) in 1869 that resulted in the legislation (the Life Assurance Companies Act passed in 1870) that formed the basis for the modern regulation of insurance. This law was consolidated in 1909 into the Assurance Companies Act to include non-life insurance. Its main requirements consisted of a deposit with a governmental body, the separation of Life Assurance and policyholders' funds from other accounts, standardization of revenue accounts and balance sheets and conditions governing mergers and liquidations.[7] There was no attempt to affect insurers' freedom of action (the "freedom with disclosure" principle). The passive inspection of accounts, however, proved ineffective to detect insolvencies. The separation of insurance funds from other accounts and deposits provided some additional security, but was also insufficient to secure overall solvency. Following the failures, during the period 1933-1935, in the compulsory motor vehicle insurance segment as a result of intense competition, the Insurance Companies Act was strengthened in 1946. Marine and aviation insurance were

brought under the Act and a requirement for compulsory solvency margins was introduced. The concept pioneered by the United Kingdom consisted of imposing a minimum paid-up capital to discourage the establishment of small and unstable companies and of a "standard of solvency that forced any company transacting non-life business to be deemed insolvent unless its total assets exceeded its total liabilities by whichever was the greater of £50,000 or 20 per cent of the premium written by the company in its last preceding financial year up to £2,500,000 and 10 per cent on the balance."[8] In 1966 the failure of nine automobile insurance companies resulted in the "radical tightening of the legislation governing the provision of insurance in the U.K."[9] The Insurance Companies Act of 1967 gave much broader powers and duties to the Board of Trade (the insurance supervisory body in the United Kingdom) to include: power to refuse or discontinue authorizations to carry on business, imposition of conditions for operation, ensuring that adequate reinsurance arrangements were made, the possibility of requesting information from any company, and a check on the fitness of company owners and managers.[10] The responsibility for monitoring the reliability of insurance companies was now the duty of a government department. After the failure of the Vehicle and General Insurance Company in 1971, "which highlighted the need for suitably qualified and competent personnel to fulfil supervisory duties"[11], further legislation was adopted to strengthen the Department's supervisory powers and duties (The Insurance Companies Act 1973). After the 1974 consolidation of the Act, many subsequent amendments were the result of the enactment of EC directives. An exception is the Policyholders Protection Act (1975)[12], which authorizes levies on the insurance industry to finance the protection of policyholders against the failure of insurers.

35. Despite the increasing concern about public protection, the United Kingdom legislator has always tried to avoid the imposition of restrictive regulations that could have hampered the development of the insurance industry, especially of the international business handled by British insurers.

2. Regulation and supervision in Germany

36. The underlying philosophy for regulation and supervision of insurance in Germany was primarily based on the desire to maximize security for the purpose of ensuring the protection of the public and stability of the financial system. Considerable attention was accordingly devoted to developing a tight regulatory and supervisory framework that controlled practically all possible aspects of insurance operations, including contract terms and conditions and investments made by insurers. Only after the Second World War were there attempts by the Government to stimulate competitive forces; these met, however, with little success because of fierce opposition by the industry. The implementation of EC directives into German law appears to have encouraged competition and has led to a decrease in supervisory intensity.

History

37. Because of pressure from the insurance industry to introduce federal legislation, the Government enacted the original law on Insurance Regulation in

1901. At that time the prevailing view in Germany was that competition was disruptive, while cartel formation and tight regulation were conducive to economic success. The insurance law fully reflected this approach with a large number of specific regulations including "market entry restrictions, minimum capital requirements, supervision of all aspects of business operations by a regulatory agency."[13] The law also gave powers to the regulatory agency "to interfere in any business operation if this was to protect the interest of the insured".[14] Major amendments to the original law were introduced in 1931 following the failure of a large insurance company. They were to fill the gaps in the supervisory framework and to increase the powers of the regulatory agency. "Larger insurance concerns were required to have their annual accounts audited by external auditors; the power to supervise larger concerns became a duty; mathematical reserve funds had to be administered by independent trustees; to counter speculative investment, rules regarding investment of reserve funds were made stricter; participation of insurers in other businesses had to be approved by the regulatory agency; and policyholders were given a preferential right in the event of insolvencies."[15] During the late 1930s and the Second World War, regulations embodying any elements of competition were abolished and "all parameters commanding the conduct of insurance business became centrally controlled."[16] With the formation of the Federal Republic of Germany in 1951 the new regulatory office of the Bundesaufsichtamt für das Versicherungswesen (BVA) was established and a new law enacted to lay down its prerogatives. There was, however, no fundamental departure from the original concept of consumer protection and control of investments. With the implementation of the EC insurance directives concerning the regulatory and supervisory framework, Germany moved to a more competitive regime.

38. The history of insurance premiums and investment regulations in Germany is marked by continuous attempts by the industry to establish premium agreements through cartel type arrangements with the help of the regulatory agency. During the 1930s until well after the Second World War price controls in insurance were maintained ("unitary tariff"). In the 1950s a dividend scheme consisting of returning excess surpluses to the insureds was adopted as a measure to introduce some competition. After unsuccessful attempts to break the cartels in the insurance sector, the Government decided in 1962 to abolish the "unitary tariff" and replaced it by a mandatory premium calculation scheme. "The new scheme was to allow firms to charge different premiums from those of other firms thus stimulating price competition, but made sure premiums of any one firm remained above its costs."[17] Cost estimates were based on projected loss experience calculated by the association of insurers and on margins for administrative expenses and for commissions calculated by the regulatory body. Profit regulations (distribution of excess surpluses to the insureds) remained in place. In 1980 the Ministry of Economic Affairs announced its intention to end premium regulation for first party liability insurance. The association of automobile insurers tried to circumvent this by establishing a voluntary cartel agreement, a strategy which failed. The association was nevertheless able to convince the supervisory body to retain some form of premium regulation in the amended law.[18]

39. Investment of insurance funds has been tightly regulated over most of the century especially in life insurance:

- before the First World War acquisition of real estate by life insurers was heavily restricted and foreign investment prohibited.

- The hyper-inflation experienced in 1923 brought important changes to investment regulations. Unfortunately these changes came too late, "Life insurance policy holders had already lost most of their savings"[19] and this had significant repercussions at the political level (end of the Weimar Republic).

- During the depression of the early 1930s, life insurers were either prohibited from investing in common stocks or only a small proportion of equity investments was allowed by special permission of the regulatory authority.

- In the late 1930s, insurers were forced to invest almost exclusively in government bonds to finance the war effort of the country. After the Second World War policyholders had again lost all their savings. Today the law is more permissive, but requires investments made by insurers to fulfil criteria on the following aspects:

  - maximum security
  - maximum rate of return
  - strict liquidity ratios
  - mix and dispersion
  - the classes of business operated by, and structure of, the insurer.[20]

40. As a result of very tight regulation very few insurance concerns have collapsed during this century, except as a result of dramatic external events. However, while being well protected against insolvencies, German policyholders have had less access to differentiated and innovative products. Also prices of insurance products have benefited less from competition and competitive gains within the industry. Another feature of the German insurance market has been that, until recently, it has shielded established companies against new entrants both foreign and domestic.

3. Regulation and supervision in the United States of America

41. The emphasis of insurance supervision and regulation in the United States has moved increasingly towards protecting the public against unfair treatment and insolvencies of insurance concerns. This is largely due to the social role that commercial insurers play in the country. Health and pension insurances, which in many countries are considered the duty of the State, are operated by commercial insurance concerns. Also "historically funds furnished by the insurance industry have greatly contributed to power the nation's industrial expansion".[21]

42. The United States insurance regulatory framework differs from that of other countries in that it is each individual state and not the federal Government that supervises and regulates insurance operations. "The states administer insurance regulations through state insurance departments. Each state tailors its insurance regulations to reflect its own interests. The National Association of Insurance Commissioners (NAIC) coordinates regulatory matters between the separate states, and recommends model insurance legislation, but has no power of enforcement."[22]

History

43. Early insurance regulation saw separation of property/casualty, life and later health business. Regulation of the different classes of business also evolved separately. However, throughout history "the life and the fire insurance industries opposed new regulations unless it showed somehow beneficial to their industry."[23] State property and casualty insurance (P & C) regulations were designed to increase tax revenues and to protect local insurance companies against non-domestic competition. ("In 1785, Massachusetts enacted the first insurance tax; in 1824, New York enacted a 10 per cent premium tax to be borne by out-of-state insurers".[24]) Also, to tackle insolvency problems, reporting requirements were introduced with the aim of improving information on the soundness of companies. ("Massachusetts required reports as from 1799 and had a general reporting requirement from 1818 followed by many other states".[25]) However, this had no significant effect on the solvency of companies. The fire business was particularly exposed to insolvency because of catastrophic events. The industry colluded to set fire insurance rates and commissions (National Board of Fire Underwriters 1866). The response of states to the insolvencies, which were not only the result of problems in the fire business but also in the life sector, took the form of establishing supervisory bodies (Massachusetts in 1855, followed by a number of other states), issuing regulations about the forms of insurance policies and acting against cartel behaviour ("anti compact" laws which by 1913 were passed by 23 states).[26] To counter increased state regulation legal action was undertaken by the industry and settled ultimately by the Supreme Court (Paul vs. Virginia (1868)), which supported insurance cartels by ruling that issuing an insurance policy was not commerce.[27] Thus, under the "protective eye" of state regulators, the cartel nature of the P & C insurance was continued until a new ruling by the Supreme Court in 1944 reversed previous rulings and held that "insurance was commerce and thus subject to federal antitrust restrictions" (The South-Eastern Underwriters Case).[28] Another major event in the United States insurance history was the formation of the National Insurance Convention (1871), which later became the National Association of Insurance Commissioners (NAIC). NAIC, an organization for cooperation among state regulators, has played and still plays a major role in drafting model laws on insurance regulations.

- After an initial boom in the life sector between 1840 and 1870, unsound practices, especially regarding marketing of products (high commissions, dividend payments not related to actual performance ...), and the recession of the 1870s brought a large number of companies to collapse.[29]

This resulted in the creation of supervisory bodies, and the introduction of reserve requirements and of restrictive investment regulations. Under the New York State Insurance Code, derived from the findings of the Armstrong Committee (1906), investments were limited to government bonds, secured corporate debt, mortgages and policyholder loans. Common stock and real estate investments were prohibited. The Merritt Committee, which was set up after the 1906 San Francisco earthquake that caused the bankruptcy of a number of P & C companies, concluded that problems encountered by insurance companies were linked to unrestricted competition and that "collaborative rate making was needed".[30] A number of states introduced laws that permitted the establishment of rate bureaux (after 1911). Tariffs compiled by these bureaux were, however, only loosely followed by competing companies. Other laws regarding investment regulations, including the so-called "enabling investment regulations"[31] imposed on life insurance companies, restricted investments to a list to be approved by the state regulatory body. These laws were gradually liberalized over time.[32]

- As a response to litigation in the South-Eastern Underwriters Case, the McCarran-Ferguson Act was passed by the United States Congress in 1945. This Act affirmed that regulation of insurance was a public interest matter and confirmed the powers of states in respect of taxation and regulation. "After the passage of the Act, insurance commissioners, acting through the NAIC, produced two model laws regulating rates, one for fire and marine and one for casualty and surety."[33] By 1951 all states had adopted new rate regulation laws.

- As a reaction to the insurance cartels, pressures to allow for increased competition developed. In 1969, New York State passed a law to enhance competitive rate setting, an example followed by a number of other states. However, the trend towards increased rate competition was braked by the high inflation that prevailed in the late 1970s.

- The insolvencies in the savings and loan business and the increased number of bankruptcies of insurance companies in the late 1980s and beginning of the 1990s is having a dramatic effect on public confidence. Great attention is currently devoted to solvency issues. There is a realization that states, however sophisticated their supervisory system, have problems in assessing the global solvency of companies that have complex corporate structures and operate at an inter-state or even on an international basis. The current debate on solvency could induce a greater involvement at the federal level. The same trend is also noticeable in international business where, as a consequence of an increase in defaults, much greater emphasis is being put on assessing the security of insurance and reinsurance concerns.

D. Monitoring of insurance operations other than by the State

44. The State is not the only entity that monitors insurers. Individuals and groupings (i.e. insurance consumers, consumer associations, shareholders, associations of insurers, etc.) check and scrutinize the operations of insurance companies and constitute a web of different controls.

1. Policyholders

45. Policyholders should be able to make a well-informed choice in their purchase decisions. They should have the possibility of comparing product characteristics, prices and quality of services offered and also assess the security of insurers. The degree of sophistication of insurance consumers has to be differentiated. For mass products (e.g. compulsory personal lines of business) the tendency of customers is to base decisions on price only. Consumer protection laws have tended to focus on these types of policies, because information asymmetry is most obvious in this area. Commercial and industrial insurance buyers enter contractual relations with insurers on a more equal footing. For this type of customer insurance decisions are part of his risk management strategy and represent part of his overall production cost structure.

2. Consumer associations

46. In most developed countries consumer associations play a role in improving market transparency and information. Through comparative surveys on prices, terms and conditions of insurance products they enable consumers to make a more informed choice. They can also form powerful lobbies that may hamper the development of a sound and dynamic insurance industry by requesting, with the help of political pressures, conditions that are not based on technical realities.

3. Shareholders

47. The prime interest of shareholders is to see that the company in which they have invested is well managed. They want enough information on the company's operations to make an accurate assessment of its performance. One must differentiate, however, between the "investor" and the "partner" type of shareholder. The first is largely interested in the level of return on his investment (short term), while the "partner-owner" type of shareholder has a longer-term interest with the aim of sharing in the operational control of the concern. This applies particularly to developing countries where many insurance companies are still owned by a small number of shareholders. Insurance companies are often sidelines of larger commercial or industrial ventures, and it frequently happens that owners do not segregate between their different interests sufficiently. Also regulatory authorities do not have enough power to impose strict separation of businesses. Recently a number of cases of cross-subsidization within family-owned conglomerates were revealed in which insurance companies' reserves were used to cover cash-flow problems in other commercial

or industrial operations of the same group. This type of behaviour and misuse of insurer's reserves should be strictly controlled and limited.

4. External auditors

48. The law usually requires accounts of insurance companies to be verified by external auditors. Auditors statements should point out any deficiencies of the audited company. The professional competence of these auditors should be beyond doubt. The duties of regulatory authorities should include verification of qualifications, competence and independence of persons exercising this profession.

5. Stock markets

49. To enlarge their capital base, more and more insurance concerns are seeking new or additional capital through public offerings of shares. Relative share prices reflect market anticipation of the performance and financial reliability of the respective companies. Companies whose shares are publicly traded generally offer more transparency to the public because of Stock Exchange rules, which normally require rather full disclosure of information.

6. Insurers' associations

50. The role of insurers' associations differs widely from one country to another. They may be simple forums but can also form strong structured entities having such functions as compilation of statistics, rating bureaux, lobbying or self-regulation bodies. These associations may formally or informally monitor members' and even non-members' dealings that might damage the image of the whole industry. In this respect they may establish Codes of Conduct and self-regulation principles. Insurers' associations may play an active role as the voice of the industry in any matters related to their business, such as drafting of new laws and regulations. They have a role in laying down professional and qualification standards and organizing related training activities. Another area where these associations should be active is promoting public awareness of risks, and they should be consulted in any matter touching on risk reduction. Because of their acquired experience in dealing with losses, they should be involved in risk prevention strategies of a country and participate in the drafting of construction and building codes, road traffic codes, safety regulations in the workplace and other rules and regulations regarding risk control.

7. Insurance intermediaries' associations

51. Associations of brokers or agents may have similar functions to those of insurers' associations, especially regarding professional standards and qualifications.

8. Self-regulation

52. Lloyd's of London is probably the best known example of self-regulation in the insurance industry. As already mentioned in paragraph 50 on insurers' associations, one method of supervision of insurance operations is through self-regulation. By setting and supervising standards, an association exerts pressure on its members to conform to a certain set of rules. This may not be as effective as state regulation, but will certainly contribute to the increased reliability and effectiveness of the insurance industry. Lloyd's of London represents a unique showcase for self-regulation and this for almost three centuries. For the most part, Lloyd's has been exempt from legislation covering insurance companies. The enabling legislation that was passed mainly governed the structure of Lloyd's (role of its Committee, Council, General Meeting, etc.) but did not touch upon operational matters. The latest Lloyd's Act (1982) leaves the regulation and supervision of members of the Society entirely to them.[34] The main belief behind the imposition of self-regulation was the need to maintain the competitiveness of Lloyd's within international insurance markets while pre-empting State intervention that might have limited flexibility to adapt to new market conditions. "The system of self-regulation that had developed deposits, annual audits, trust funds, a central fund, premium income limits and so forth, came out of the recognition of the need to protect the standing of its market."[35]

Chapter III

INSURANCE SUPERVISION

53. This chapter provides a brief overview of the duties a supervisory authority should perform. It does not attempt to formulate a model supervisory framework.

A. Duties of supervisory authorities

54. A regulatory and supervisory framework should provide a definition of insurance operations, including which type of entity can provide insurance services and which insurance activities are to be monitored by a supervisory body. In most countries there is also a separation between life and long-term insurance on the one hand and other classes of business on the other. The scope of supervision differs widely from country to country for reinsurance and intermediary (brokers and agents) activities. However, for the supervision of direct insurance operations, common features can be found among a number of countries. In most countries insurance companies' activities are limited to insurance business. Companies may not, for example, hold majority stakes in businesses with other than insurance activities. Moreover, insurance operations can only be carried out by an authorized insurance concern. Recently, however, in some countries, other financial services intermediaries such as banks have been allowed to offer insurance products.

1. Insurance company formation

55. Organizational structure: In almost all countries, an insurance concern, before starting its operations, has to take the legal form of a company, either limited by shares or by guarantee (mutuals and cooperatives).

- To be allowed to provide services within a country, in the majority of cases the company must establish itself in that country. That is, it has to operate through a head office, or, if it is a foreign company, through a branch office situated in the country.

56. Before commencing business the company is usually required to obtain a licence from a designated governmental authority authorizing it to carry on one or several classes of insurance business. The licence may be renewable (each year) or be valid for an unlimited period of time given continuous compliance with set rules and regulations. The application to obtain a licence usually includes:

- the name and address of the company;
- by whom has it been formed (majority shareholder) and who is/are the manager(s) and directors;
- the articles of incorporation or of association;
- a business plan mentioning the class or classes of business the company intends to carry out and target clients;
- an initial balance sheet stating, *inter alia*, formation expenses and paid-up capital;
- a forecast of operating accounts during initial years, giving details concerning the financial aspects of the first few years of operation, including the expected liquidity position and estimates of the financial means necessary to cover solvency margins and technical reserves. The operating plan should also contain some details on the intentions of the company regarding reinsurance coverage of its operations (reinsurance plan);
- in order to guarantee compliance with minimum capital requirements, companies are often required to deposit part or the whole of the paid-up capital with a designated entity (Central Bank, government body, etc.). These deposits will generally be considered to form part of the company's investments;
- in a number of countries, new insurance companies are requested to file with the licensing (supervisory) authority, for its approval, copies of policy forms, rating structures and the technical base for their calculations.

Only after the company has been incorporated and has obtained a licence can it begin to write insurance business.

2. Ongoing supervision of operations

57. The ongoing supervision of insurance companies' operations may include a number of different duties:

(a) Monitoring of legal and statutory requirements

Supervisory bodies have to see that all licensed (authorized) insurers are acting in compliance with the latest laws, rules and regulations. The supervisory body must also check whether companies are operating in conformity with their latest approved articles of incorporation and operating plan, and, if so required, verify that policy forms and rates actually in use conform with those filed by the respective company. With regard to directors and management of insurance companies, any new nomination or replacement must be in conformity with criteria of fitness set by law and be duly examined and authorized by the supervisory authority.

(b) Prudential regulation and financial soundness

58. A primordial function of a supervisory body is to make sure that companies are financially sound and reliable. A number of prudential regulations have to be complied, with and it is the duty of the supervisory authority to ensure they are respected.

59. Capital and solvency margin requirements: In most countries minimum capital requirements have been established. Insurance companies have to meet (or exceed) these requirements continuously during their operating life. These minimum requirements may vary with the size and type of business insurers are underwriting. In a number of developing countries there is now a realization of the importance of adequately capitalizing insurance concerns, especially after disinvestment of the State from the sector and the concomitant disappearance of the "State guarantee". Private or privatized companies have to be self-reliant as regards their capital funding and solvency to preserve their long-term viability. Capital and reserving requirements have a bearing not only on solvency but also on the structure of markets: the higher the standards are set, the more concentrated a market is likely to be. The number of companies in a market is not a valid measurement of the level of competition in the market.[36] A market with a small number of financially sound companies of roughly equal size might have more competitive attributes than a market where a large number of unequally sized companies co-exist with a few dominant concerns. Capital and reserving requirements and their effect on company size directly shape the retention capacity of markets. Companies with large amounts of capital can have higher retentions and make less use of proportional reinsurance treaties.

60. Historically, to be solvent an insurance company's total assets had to exceed its total liabilities. However, past experience has demonstrated that for an insurance company to cover fluctuating and sometimes unexpected surges in its obligations, its total assets should show a certain surplus in excess of a minimum solvency margin. The original concept, first introduced in 1946 by

the United Kingdom (see paragraph 34), stipulated that total assets of a non-life company needed to exceed total liabilities by a margin amounting to some 20 per cent of premium written by the company. This 20 per cent margin is applied in many countries (for example, Australia, Malaysia, Singapore, Thailand) and is a basis for the slightly more complex requirements of the European Union. A number of other countries including developing countries (Central and Latin America) have introduced new solvency margin requirements along the lines of European Union requirements in the course of liberalizing their markets.

61. The minimum solvency margin requirements as introduced by European Union Member States are as follows:

- for property and casualty insurers the solvency margin must be equal to the higher of the following calculations:
  16 per cent of the gross premiums minus reinsurance ceded (the allowed deduction of which cannot exceed 50 per cent) minus claims paid during the year; or
  23 per cent of the average gross claim expenditures for the last three financial years minus reinsurance recoveries (again with a maximum allowed deduction of 50 per cent).[37]

- "for life assurance companies the required solvency-margin is equal to the sum of three results. The first result is 4 per cent of the mathematical reserves, with a maximum of 15 per cent being deducted for reinsurance cessions. The second result is 3 per cent of the capital at risk, after allowing a maximum of 50 per cent for reinsurance cessions. The third result is calculated on the basis of the premiums for supplementary insurances."[38]

The solvency margin calculation represents a powerful tool to regulate growth of premium volume, since to increase the solvency margin without injecting new capital requires profitable underwriting.

62. For both life and property and casualty insurers:

- if the company maintains its solvency margins, it is deemed financially sound;
- if the company's solvency margin is insufficient but above one third of the set minimum, the company has to submit a plan for the restoration of a sound financial position to be approved by the competent supervisory authority (one third of the solvency margin goes into a guarantee fund);
- if the company's margin is lower than one third of the set minimum (insufficient for guarantee fund coverage), the supervisory authority requires the company to submit a short-term financing scheme and may also restrict or prohibit free disposal of the assets of the company.[39]

63. In the United States of America the Commissioner of Insurance in each state is responsible for ensuring that insurance companies are well-managed and financially sound. In order to identify emergency problems, insurance departments have developed informal "rules of thumb" for various ratios, including the ratio of premiums to shareholders' funds. Generally the ratio of net premiums written to surplus has been limited to 3 or 4 to 1. These guidelines are not published and can vary with the state of the economy, size of the company, types of risk insured, etc. The NAIC has also devised an "early warning test" that consists of a series of financial ratios computed annually for the purpose of identifying troubled companies. This test includes ranges for each ratio that are considered passing or failing. Individual states differ as to how compliance with these ratios is enforced.[40]

64. Technical reserves: Besides the legal and other reserves common to all commercial undertakings, insurance companies establish technical reserves that are so calculated as always to cover contractual commitments to policyholders and other beneficiaries. The supervisory authorities have a special responsibility for ensuring that all legal and regulatory provisions in this respect are complied with. Basically these reserves consist of the following:

(i) For life insurers:

65. Mathematical reserves are reserves traditionally associated with life insurance and other long-term insurances (sickness insurance) in which the risk often increases with time while the premium remains constant. These reserves are mandatory and in most countries regulations for mathematical reserves are more stringent than those for other kinds of technical reserves. This is because mathematical reserves contain large elements of savings, which are managed for policyholders by insurers acting as trustees for long periods of time. A number of countries have enacted laws or regulations that provide for the calculation of mathematical reserves by prudent actuarial methods. Evaluation of these reserves by qualified actuaries is an essential element of any prudent regulatory and supervisory framework.

(ii) For non-life insurers:

66. Premium reserves (reserves for unexpired risk): Non-life insurance premiums are normally payable for annual periods beginning at any point during the financial year. Consequently, the risk may not have expired by the end of the financial year and a reserve must be set up to cover the part of the premium for the period during which the insurer is still liable for any claim. The calculation of these reserves may be made contract by contract or by statistical methods based on past experience and on groupings and samplings.

Reserves for outstanding claims: Reserves must be established to cover claims notified to the insurer but unsettled on the date on which the balance sheet is drawn up. In a number of countries outstanding claim reserves are subdivided into outstanding claims reserves and reserves for claims incurred but not yet reported (IBNR).

Fluctuation reserves: They may be established to cover fluctuations in loss ratios over future years, or for cyclical risks. Other reserves such as reserves for catastrophic or large risks may be set up for low frequency high exposure risks.

Other reserves In a number of countries reserves with names which differ from country to country have to be established (either by life or non-life insurers), consisting mostly of an additional security to compensate for insufficiently precise evaluation of conventional technical reserves or changes in the value of their covering assets. In most countries foreign companies have to comply with reserving requirements in the same manner as domestic companies. Often these reserves may have to be established within the countries to cover risks underwritten locally.

67. Investment regulations: Invested funds of insurance undertakings should differentiate between the assets matching liabilities towards shareholders and trade creditors (capital and legal reserves) and those representing technical reserves, which are liabilities towards policy holders and third party beneficiaries. While for the first two categories the common commercial provisions apply (strict rules apply, however, to deposits, see paragraph 56), in most countries specific rules have been enacted regarding the investment of assets representing technical reserves, especially in respect of mathematical reserves. In addition to the general requirements for security and liquidity, most countries have imposed regulations mentioning the types of permitted investments and maximum permitted holdings for technical reserves. In most developing countries insurance companies are also not allowed to invest abroad (following the principle of localization of investment).

68. The political strategy of channelling insurance funds to target developmental areas of the economy should take into account the basic investment principles for insurance funds (security, profitability, liquidity). This is particularly important when insurance markets are to be opened to foreign companies. The latter might derive a better return from investments made by their head office or from investing part of the funds of the branch office operating in the country in markets bearing higher returns. For the ultimate benefit of the insurance consumer and the overall economy, distortions of the allocative efficiency of the investments of institutional investors should be avoided as much as possible. Also, amounts invested with a single borrower (except for the State) should be limited, in order to soften the impact of failures of family-owned types of conglomerate. Concentration in one type of investment, for example real estate, may also have disastrous consequences, due to the fact that the liquidity of such assets may not be assured as they are unlikely to be quickly saleable.

69. In a number of developing countries, a high proportion of the content of many insured risks is only replaceable by imported materials or services. Foreign currency reserves should be maintained to match underlying potential liabilities, especially in times of high inflation. In some countries,

"investment provisions stipulate that the assets must be expressed in the same currency as the underwriting liabilities (matching assets). There are, however, exemptions in so far as there are limits for investments in certain categories."[41]

70. To be able to assess the solvency of an insurer correctly it is of the utmost importance that its assets, especially insurance funds and their underlying investments, are accurately valued. In this respect the most prudent accounting principles should be used. In most countries evaluations are at acquisition or book cost, and deductions for depreciation are allowed. In some countries, assets are valued either at acquisition cost or at market value, whichever of the two is the lower. A few countries allow the less conservative evaluation at market value; this can present difficulties in estimating the real value of assets on a reliable basis, and might only be feasible in countries with efficient investment markets. On he other hand it offers opportunities as it allows companies to utilize increases in their asset value to support the growth of underwriting volumes.

(c) Setting and control of rates and tariffs

71. In many countries supervisory authorities have the right to require information about the rate structures in use by an insurance company. In a number of countries insurers have to file any new rating table for approval with the regulatory body before its implementation, while some authorities only require submission of new rates for information. The control and fixing of rates by the supervisory authority may theoretically represent the ultimate consumer protection, as all elements of an insurance operation are in the hands of the authority. It should apply all prudent measures possible so as to ensure the almost infallible reliability of the insurer in question. A weakness of this system is that State regulators may be tempted to bow to political pressure for cheap insurance prices at the expense of ensuring that insurers maintain maximum solvency and security. The concept of fixing rates within certain ceilings to allow for adequate coverage of the underlying risk and for a small profit for the insurance company is very often applied to compulsory mass products, such as motor insurance. The perception is that for these types of product authorities have to secure affordabililty, availability and fair treatment of insurance consumers. Often tariffs are set by "committees" within national associations of insurers together with the supervisory authority. Since the determination of premium rates calls for the utilization of the largest possible amount of statistical and economic data, an association of insurers will possess broader experience than a single insurer. Coordinated price fixing certainly hampers competition and product innovation, but for young markets a period of price stability may give consumers a better understanding of the intricacy of insurance products.

72. The law of large numbers enables insurance companies to improve the predictability of losses by pooling a large number of similar independent risks. One of the consequences is that large-sized insurers may gain a competitive edge if they are able to underwrite large numbers of homogeneous risks on a larger

geographical spread. However, insurance technology has now advanced and methods of rating, based on other principles, such as statistical inference and portfolio management theory, which do not need large numbers for their application, allow niche players to operate successfully. As a result medium-sized companies may also be profitable, provide good services and offer tailor-made products. Prices of mass products can be undercut through risk segmentation, marketing, direct writing, multi-peril writing, globalization, etc. while sound solvency requirements are still respected.

73. Regulators may have difficulty in differentiating between a competitive edge and commercial malpractice (dumping practices). Further difficulties arise with the problems of cross-subsidization between business lines, when losses on one product are covered by in-built surpluses of other lines. The losses in motor insurance, which are often covered by surpluses in fire business are a typical example. This practice represents unfair treatment of fire policyholders. When markets are opened to outside competition domestic companies might no longer be able to cross subsidize because of competitive pressures, with the result that certain "protected" lines might experience dramatic rate increases. The integration of expected returns on investments into rating calculations poses further problems, especially in countries where investment markets (stock exchange, bond markets, real estate, money market, etc.) are still very fragile and volatile.

74. The supervisory body must decide which kind of product features should be promoted in view of the best interests of the consumer: security, price competitiveness, diversity, tailor-made products, quality of services. Authorities have to adapt their insurance legislation to the needs of their insurance consumer, an ongoing process since consumer interests are shifting. A new trend in a number of countries is a movement away from ex-ante scrutiny of rates and conditions towards ex-post monitoring of solvency margins and reserves. This allows for a freer regime in product design and price setting but imposes more responsibility on the management of companies.

(d) Contractual relations

75. In many countries insurers are required to submit the documents that form the basis of the contractual relationship with policyholders to the supervisory authority, in particular pro forma policies, policy conditions and proposal forms. Approval of these documents is often a prerequisite for granting a licence to operate. The supervisory authority should ensure that the contractual relationships have a legal basis that is not prejudicial to the interests of the insured, since the insured does not generally participate in the negotiations regarding policy clauses. By ensuring the correctness of these clauses the supervisory authorities fulfil one of their primary functions.

(e) Management expenses and acquisition costs

76. After claims, commissions paid to producers of business are often the largest item of insurers' expenses. Some countries, especially those where

strict rate controls are applied, have enacted rules for the purpose of limiting commission levels.

(f) Transfer of portfolios, mergers and acquisitions

77. The insurance regulations of many countries provide for the possibility of transferring the portfolios of one company to another insurer subject to certain conditions. Portfolio transfers have to be authorized by the supervisory authority and in most cases acceptance by a certain percentage of policyholders is sought. Policyholders should be informed when a transfer is proposed (through individual notices or in the official gazette and relevant newspapers). Supervisory bodies should ensure that the portfolio transfer does not damage the interests of policyholders.

(g) Suspension, termination, liquidation

78. An insurer's operation may be temporarily suspended or terminated upon a decision by the company itself or by the supervisory authority. In the case of voluntary suspension or termination, the supervisory body and policyholders have to be informed and the commitments of the insurance company must be honoured until contractual obligations cease. Suspension or termination may also be imposed by the authorities when legal requirements and the conditions on which the licence was granted are no longer fulfilled. This often reflects an unsatisfactory financial situation. When withdrawing an authorization the prime duty of a supervisory body is to safeguard the interests of policyholders and third party beneficiaries. In the case of insolvency of an insurer a liquidator is generally named who, in close coordination with the supervisory authority, is responsible for the proper winding up of the business. In most countries policyholders (especially life policyholders) have preferential rights if the insurance company becomes insolvent, which give them priority over other creditors.[42] In some countries "guarantee funds" have been established by levies on premiums or insurance operations as an additional protection for policyholders and other beneficiaries in the event of failure of an insurance concern. The utilization of these funds is very often the prerogative of the supervisory body while their administration may be handled by another governmental department or by the national insurance association. When a branch of a foreign insurance company fails the same rules apply; however, consultation with the head office of the foreign branch and its competent supervisory body should be sought with a view to achieving the best possible solution for policyholders.

(h) Cross-border insurance trade

79. While some insurers in developing countries do accept reinsurance business from abroad, the great majority of developing countries are net importers of reinsurance. In a number of countries reinsurance contracts, especially those entered by insurers also transacting direct business, are subject to supervision because an unsound reinsurance policy might upset a company's stability and endanger its direct portfolio. The monitoring of these reinsurance contracts is often less strict than monitoring of direct business and in many cases simply

requires copies of treaties and other contractual documents and the list of reinsurers to be submitted to the supervisory authority. Submission of these documents is not aimed at evaluating the fairness of reinsurance contracts but rather at ensuring observance of technical and financial requirements. Monitoring of the security of reinsurance providers is also an important issue. "The task of monitoring the security of reinsurers falls principally upon ceding companies, since it is up to them to choose their reinsurers. Such security analysis is, however, not always conclusive, this is either because of lack of necessary data to serve as a basis for assessment or because of the inability of the ceding company to use the available data to obtain an appropriate picture of the reinsurers".[43] In this respect, insurance supervisory authorities can play a role in "exercising some control over the choice of reinsurers by the ceding companies to ensure the good security of chosen reinsurers. However, such control will be ineffective if the supervisory authority itself lacks sufficient knowledge of the international reinsurance markets and international reinsurance practice".[44]

80. In some countries, the supervisory authorities require that reinsurance treaties concluded by domestically established concerns contain clauses providing that technical reserves must be left at the disposal of the ceding company (deposits). This often applies to reinsurance treaties concluded with foreign concerns. The main purpose of such a requirement is to ensure that the local insurer has immediate funds from reinsurers to settle claims as they arise, and to provide to the ceding company an additional degree of security as, in the event of insolvency on the part of the reinsurer, such deposits can serve to discharge the liabilities of the reinsurer. International reinsurers have drawn attention to the fact that the return rates on deposits held by ceding companies are often far lower than rates that would actually be earned by them on these funds.

B. Tools at the disposal of supervisory authorities

81. The objective of authorities should be to determine the true financial situation of insurers with the maximum degree of certainty. To this effect they have a number of tools at their disposal.

1. Reporting requirements

82. The prime tool is checking mandatory returns from companies. These comprise, *inter alia*, balance sheets, operating accounts, revenue accounts, profit and loss accounts, detailed reporting of technical reserves, assets statements with their valuations and solvency ratios. There should be strict rules governing the timely submission of returns as well as their assessment by authorities as to make monitoring of returns effective and relevant; the format of these returns should be such as to enable the authorities to carry out their analysis efficiently. Returns should be sufficiently detailed, as the financial analysis may entail the calculation of a great number of ratios to provide a check of many different financial aspects. As mentioned before, the time-frame is of the utmost importance since the financial situation of an insurer may

deteriorate very quickly, especially when it is already in trouble. Adequate analysis and quick response may prevent further deterioration. Supervisory bodies have difficulty in achieving timely and efficient assessment of returns, mostly due to lack of trained human resources. However, today, with data processing technologies and automation, the time factor may be more manageable. Often in this process too much time is devoted to scrutinizing healthy companies, which diverts resources from the real problem areas. The assessment system should provide for a rapid identification of the companies that have difficulties and most resources should then be targeted on the careful checking of these entities.

2. Inspections

83. In most countries supervisory authorities are empowered to carry out on-site inspections of insurers' offices. This is a valuable method by which authorities can verify the information provided to them at regular intervals and obtain additional information from an insurer. These inspections may be carried out periodically and without forewarning. To be effective, inspectors from supervisory authorities should have access to any document and the premises of a company. Inspections may be very extensive or only targeted at specific operations. The results of these inspections are usually confidential, and findings and conclusions are contained in a report to the head of the supervisory authority. The inspectors, who very often constitute the largest category of personnel of the supervisory authorities, must have the necessary qualifications and experience.

3. Public complaints

84. In a number of countries formal offices have been established either within the supervisory authority or set up as ombudsmen's offices to respond to insurance customers' complaints. Their purpose is to streamline administrative procedures and sometimes to serve as an alternative to judiciary proceedings. For supervisors they represent a very useful source of information concerning the reliability of companies. In most cases companies in difficulties delay claim payments or settle claims in an unfair manner. Complaints should therefore be examined carefully as they can provide a useful warning for the supervisory authority when an insurer is getting into trouble.

4. Dynamic role of supervisory authorities

85. The soundness of an insurer can in most cases only be established from a variety of sources. The returns, results of inspections and public complaints constitute the factual part of an assessment. In addition, supervisory authorities should seek as much informal information as possible on the true state of all insurers and on the whole insurance sector's affairs. This can be achieved by a continuous formal and informal dialogue with individual insurers and with associations representing parts or the whole of the industry. The supervisory authority should be the focal point within the government for all matters concerning insurance and should have a dynamic influence on the evolution

of the insurance industry. Regulatory bodies should not only be responsible for monitoring the reliability of insurance businesses but should also improve the effectiveness and efficiency of the insurance system through their interrelationships with the industry and the executive part of government. Initiatives for new laws and regulations affecting insurance may be suggested by the supervisory authority after careful consultation and negotiations with all concerned players.

C. Organization, structure and powers of supervisory authorities

1. Human resources

86. The effectiveness of a supervisory body is mainly dependent upon the human resources at its disposal. When a regulatory office is being established or strengthened, human resources development is of critical importance. At the hiring stage, qualifications, especially insurance knowledge, should be carefully considered. Clear criteria that match qualifications and experience to job requirements have to be established. For example an inspector's post calls for the ability to work independently, and a strong character may be required. On the other hand a post at headquarters may primarily require the ability to work as part of a team. Integrity and honesty are essential for all posts within a supervisory body. To keep up with the times, ongoing training and retraining of key personnel is a necessity. It is essential for employees to keep up with the competence levels of private industry colleagues.[45] Career perspectives and employment packages need to be made attractive to avoid a high staff turnover, which is a problem in a number of developing countries because of discrepancies in employment conditions between the State and the private sector. "Binding training programmes" might be offered whereby education and training is paid by the government on condition that trainees serve within the regulatory department for a minimum period of time or else reimburse the expenses incurred.

2. Powers of enforcement

87. To perform their duties properly the supervisory authorities should have autonomy of action and be free from any interference by political or other groupings. They should also be shielded from politically biased action by the government. The Commissioner heading the supervisory body should have direct access to the Minister responsible for the sector in question. To be respected, the authority should have the power to take rapid remedial action against insurers that fail to comply with the rules of financial security. To increase information and transparency, all reports (including reports on troubled companies) requested by the Commissioner should be handed to the responsible Minister and be published as a self-standing document or in the official government gazette.

3. Organizational structure

88. The structure of a supervisory authority will have to reflect its functions (inspection unit, returns unit, public complaints unit, etc.), but to maximize the flow of information between the different units and be able to assess the "true state of affairs" in the industry more clearly, the organizational chart should be as horizontal as possible. There should be an ongoing exchange of information on this between all levels of the different units, and it is important to maintain both formal and informal paths for communication.

4. International cooperation

89. The international nature of insurance business requires supervisors to have constant contacts with their counterparts in other countries. The increasing complexity of insurance and its operating structures have rendered an assessment of the security profiles of international players more difficult. Greater dialogue among supervisory authorities is necessary to amass more complete information on transborder operations. In developing countries it is still difficult to obtain satisfactory information on terms and conditions in international markets. In this respect supervisory authorities may play the role of a focal point for improving market information. One of the areas in which international cooperation between supervisory authorities could usefully be developed concerns the harmonization of insurance laws, regulations and practices. In order to have more efficient international and national markets a move towards more standardized practices seems to be essential. Another area where international cooperation could create considerable economies of scale in terms of cost is training. Because of the specialized aspect of insurance supervision and the small number of people involved, formal training in specific areas of insurance supervision is scarce or even non-existent. Many countries have internal training courses for supervisory staff but the United States is the only country in which training for supervisors is available through independent courses where anybody who pays the fee may attend. However, the cost of such training through the National Association of Insurance Commissioners (NAIC) is often out of the reach of most developing countries. There is a need therefore to organize more affordable ad hoc training on a regional basis. International organizations, bilateral donors and interested sponsors can play an important role in this respect.[46]

CONCLUDING REMARKS

90. As mentioned before in this note, a number of developing countries have already introduced state-of-the-art insurance legislation and regulations in an environment governed by market principles. What is still a source of difficulty is their actual "in fact and in spirit" enforcement. The establishment and strengthening of independent and strong supervisory bodies that can rely on a

coherent and unambiguous regulatory framework for insurance would do much to help in this task, while contributing to greater market efficiency and better protection of insureds.

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NOTES

1. See also "Insurance in developing countries: An assessment and review of developments (1989-1993)" - report by the UNCTAD secretariat (UNCTAD/SDD/INS/2/Rev.1), chapter II on Insurance Regulation and Supervision; "Privatization of insurance enterprises and liberalization of insurance markets" - report by the UNCTAD secretariat (UNCTAD/SDD/INS/3/Rev.1).

2. The General Agreement on Trade in Services (GATS) Annex on Financial Services, Article 2 (a).

3. The General Agreement on Trade in Services (GATS) and document UNCTAD/SDD/INS/3/Rev.1.

4. August Angerer, "Insurance supervision in OECD member countries", *Policy Issues in Insurance*, OECD publication, (Paris, 1993), pp. 68-69.

5. Sigma, Swiss Reinsurance Company, 4/93.

6. Jörg Finsinger, Elizabeth Hammond and Julian Tapp, Insurance: Competition or Regulation, Institute for Fiscal Studies, *IFS Report Series*, No. 19 (1985), p. 5.

7. *ibid.*, page 21.

8. *Regulation of Insurance in the United Kingdom and Ireland*, (Kingston upon Thames: Kluwer Publishing, 1983), p. B1-04

9. See Finsinger *et. al.*, *op. cit.*, p. 24.

10. *Ibid.*, p. 25.

11. *Ibid.*, p. 25.

12. *Ibid.*, p. 26.

13. *Ibid.*, p. 50.

14. *Ibid.*

15. *Insurance Supervision in the Federal Republic of Germany*, Gesamtverband der Deutschen Versicherungswirtschaft (Koln, September 1990).

16. See, Finsinger *et al.*, *op. cit.*, p. 52.

17. *Ibid.*, p. 54.

18. *Ibid.*, pp. 54-55.

19. *Ibid.*, p. 56.

20. *Ibid.*, p. 56.

21. Harold D. Skipper, "Insurer solvency regulation in the United States", *Policy Issues in Insurance*, OECD publication (Paris 1993) p. 75.

22. *Ibid.*, p. 79.

23. *Ibid.*, p. 85.

24. *Ibid.*, p. 86.

25. *Ibid.*

26. *Ibid.*, p. 87.

27. *Ibid.*, p. 88.

28. *Ibid.*, p. 95.

29. *Ibid.*, p. 89.

30. *Ibid.*, p. 92.

31. *Ibid.*, p. 94.

32. *Ibid.*

33. *Ibid.*, p. 99.

34. See Finsinger *et al.*, *op. cit.*, p.49.

35. *Ibid.*, pp. 42-43.

36. *Trade and Development Report, 1988* (UNCTAD/TDR/8), annex 4. United Nations publication, Sales No. E.88.II.D.8.

37. See Angerer, *op. cit.* p. 32, and Guy Simonet, "Une approche de la solvabilite de l'assureur dans les pays de la C.E.E.", *Policy Issues in Insurance*, OECD publication, (Paris, 1993), p. 174.

38. *Ibid.*, p. 32.

39. See, Simonet, *op. cit.*, p. 176.

40. *Insurance - Interpretation of Accounts in the International Insurance Market*, Arthur Andersen & Co., Hartford, 1987, p. 109.

41. See Angerer, *op. cit.*, p. 37.

42. *Ibid.*, p. 53.

43. "Reinsurance security" - study by the UNCTAD secretariat (TD/B/C.3/221/Supp.1), January 1987, pp. 34-35.

44. *Ibid.*, p. 35.

45. R.L. Shaw, "Economic liberalization and its effect on the insurance industry". African Insurance Organization Conference, Nairobi, 1992, p. 8.

46. UNCTAD/SDD/INS/2/Rev.1, *op. cit.*, chapter XI.